

**Teachers' Retirement Board  
Investment Committee  
Open Session**

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**Subject: Real Estate - Real Estate  
Policies and Procedures**

**Item Number: 7**

**Attachment (s): 1**

**Action:   X**

**Date of Meeting:   May 6, 1998**

**Information:**

**Presenters:   Mr. Pleis**

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**EXECUTIVE SUMMARY**

One of the 1997/98 objectives approved for the Investment Branch was to evaluate the appropriate risk and return composition of the real estate portfolio. In April 1998, the Investment Committee determined that the primary role of investment real estate is to provide diversification of investment returns. The Investment Committee approved a risk/return profile for the composite real estate portfolio of 75% low to moderate risk assets and 25% moderate to high risk assets.

Attachment 1 provides policies and procedures to be used in the management of the investment real estate portfolio. Policies and procedures provide parameters that will ensure prudence and care in the management of the portfolio while allowing sufficient flexibility to control risk and capture investment opportunities. Policies are designed to be static in nature and will be returned to the Investment Committee prior to changes being implemented. Procedures describe the policy implementation process and must be dynamic in nature to facilitate the adaptation to the changing risk matrix in the marketplace.

**RECOMMENDATION**

Staff and PCA/E&Y Kenneth Leventhal recommend approval of the investment real estate policies and procedures.

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## **INTRODUCTION**

In accordance with the Investment Management Plan, the California State Teachers' Retirement System (STRS) has established an allocation for investment real estate, an illiquid equity related asset, using internal staff and external specialized professionals. The primary objective for investment real estate is to improve diversification of the overall investment portfolio. The investment real estate portfolio will also have secondary objectives to achieve a rate of return which corresponds to the amount of risk outlined in the real estate portfolio risk/return composite approved by the Investment Committee and to provide a stable cash flow to the investment portfolio.

Investment real estate can be divided into three broad categories of risk: (1) low risk, (2) moderate risk, and (3) high risk. Each risk category contains certain characteristics which have been included as Exhibit 1. STRS investment real estate portfolio will have a target of 75% low to moderate risk and 25% moderate to high risk.

STRS investment real estate portfolio may consist of real estate assets purchased and owned by three main investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.

The STRS' Board has established the asset allocation and strategic objectives for the real estate portfolio. The purchase, management and sale of all types of real estate investments are performed by external professionals which are monitored and evaluated by internal investment officers and an external real estate consultant. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external real estate consultant reports directly to the STRS' Board.

This manual will establish the policies and procedures involved in the management of investment real estate. The policies are designed to set boundaries for expected performance, diversification, and investment structure. The procedures are designed to provide guidelines for the implementation of the approved policies. A flow chart is provided to establish context for the policies and procedures presented.

Please note: This flow chart is not available in electronic format at this time.

## **INVESTMENT REAL ESTATE POLICIES**

### **May 1998**

The following represent approved policies to be utilized in the management of the California State Teachers Retirement System's (STRS) investment real estate portfolio. The policies are designed to set boundaries for the expected performance, diversification and investment structure. Policies approved by the STRS' Board cannot be altered without explicit direction from the STRS' Board.

- 1. Laws and Statutes** - The investment real estate portfolio of the California State Teachers' Retirement System is to be invested, managed and sold in a prudent manner for the sole benefit of STRS' participants and beneficiaries in accordance with the Teachers' Retirement law and other applicable statutes. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the investment real estate portfolio.
- 2. Role of Investment Real Estate** - The primary role of the investment real estate portfolio is to provide improved diversification to the overall investment portfolio. Secondary objectives are to generate an enhanced yield to the actuarial rate assumption and to provide stable cash flows.
- 3. Portfolio Risk Composite** - STRS has established a composite risk range for the investment real estate portfolio. A target of 75% low to moderate risk and 25% moderate to high risk was approved. The definition of the different risk levels has been included as Exhibit 1.
- 4. Portfolio Cash Flow** - The projected cash flow for new acquisitions in the low to moderate risk portion of the investment real estate portfolio is expected to meet or exceed the actuarial rate assumption over a five year horizon. Exceptions to this policy must be approved in writing by the Chief Investment Officer.
- 5. Property Type** - The property types used for direct investments in the real estate portfolio are defined as Industrial, Land, Multi-Family Residential, Natural Resources, Office, Retail, Single Family Residential, and other property types as approved in writing by the Chief Investment Officer.

**6. Geographic Location** - Geographic regions for investing are defined as the location of the individual property. The geographic breakdown is expressed as Mid-West, East, South, West, and International.

**7. Investment Ownership Structure** - STRS can invest and hold real estate assets in the following three investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.

**8. Diversification Guidelines** - The direct investments contained in the investment real estate portfolio shall have a strategic target and range established for the following diversification criteria: (1) property type and (2) geographic location. The target and range for each criteria are included as Exhibit 2. Purchases or sales shall not be completed for the sole purpose of aligning one specific criteria. Projected rate of return, composite risk profile, and other policies should receive consideration in all transactions.

**9. Investment Limitations** - Graduated limitations of daily buying and selling cash, securities, and properties for aggregate real estate equity investment portfolio transactions are as follows (including lock box transactions):

Associate Investment Officer	\$ 1 million
Investment Officer I	\$ 5 million
Investment Officer II	\$ 10 million
Investment Officer III	\$ 20 million
Director of Real Estate	\$ 50 million
Chief Investment Officer	\$ 100 million

**10. Discretionary Authority** - The rejection decision for properties, co-investments, and secondary interests is delegated to staff with the stipulation that all investments are subject to the appropriate due diligence as defined in the real estate procedures.

The approval of major capital decisions including the decision to acquire, finance, refinance, renovate, expand, or sell is delegated to Staff considering the following stipulations:

- A. Due diligence process shall be consistent and appropriate as defined in the investment real estate procedures.
- B. Maximum amount of the commitment should not exceed \$100 million.

C. A final recommendation report will be presented to the Investment Committee as soon as practical after the transaction is completed.

**11. Authorized Signers** - Authorization letters which indicate who may sign on behalf of STRS shall be delivered to the appropriate parties. Whenever a change in authorized signers(s) occurs, the effected parties shall be notified within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer.

**12. Reporting** - STRS' real estate consultant shall monitor the investment policies and report to the STRS Board as requested.

## INVESTMENT REAL ESTATE PORTFOLIO PROCEDURES DIRECT INVESTMENTS

The Board adopted the Investment Management Plan, which was originally drafted in 1986, and has been periodically updated to reflect the changes that have occurred with the investment strategy and policy. The Investment Management Plan mandates the investment of plan assets in four broad categories: public equity, public debt, private equity, and private debt. The following reflects procedures for investment real estate, part of private equity:

### **Delegated Roles and Authority**

- 1. STRS' Board** -- Establishes the role of the investment real estate program and approves the asset allocation target and range and risk profile of the investment real estate program. Directs the Chief Investment Officer (CIO) and Real Estate Consultant to periodically report on the compliance with established policies and procedures.
- 2. Chief Investment Officer** -- Establishes the program guidelines in such areas as (1) evaluating properties, (2) declining or approving of purchase, sale or refinance (within the amounts delegated by the Board), and (3) establishing targets and ranges for diversification purposes as shown in Exhibit 2.
- 3. Real Estate Consultant** - Reports directly to the Investment Committee on matters of policy. Monitors the performance of the real estate portfolio and compliance with approved policy.

### **Acquisitions/Commitments**

- 1. Investment Officer** -- For purchase transactions, the investment real estate unit receives and reviews offering memoranda from the real estate advisor. The offering memoranda provides an overview of the investment property with terms and conditions of the proposed purchase. The investment officer(s) review and analyze the principal terms and conditions of the proposed purchase.
- 2. Director of Real Estate** -- After analyzing the terms and conditions, if there is sufficient interest and compatibility, the investment officer may contact the advisor to discuss the proposed purchase. The investment officer(s) will discuss the proposed purchase with the Director of Real Estate. After discussion, the Director of Real Estate



may present the proposed purchase to the Chief Investment Officer. A detailed due diligence process will be initiated unless the Chief Investment Officer disagrees. To facilitate the due diligence process an independent fiduciary or STRS' real estate consultant may be utilized to assist in the evaluation. Written documentation of the due diligence process is important to be included in the material for future reference.

## **Dispositions**

- 1. Investment Officer** -- On sales transactions, the investment officer(s) will discuss the proposed sale with the Director of Real Estate. After discussion, the Director of Real Estate may present the proposed sale to the Chief Investment Officer. A detailed disposition process will be initiated unless the Chief Investment Officer disagrees. To facilitate the sales process a real estate advisor, independent fiduciary or STRS' real estate consultant may be utilized. An offering memoranda designed to be incorporated in an auction type format will be prepared by the real estate unit or real estate advisor. The offering memoranda will provide an overview of the investment property with terms and conditions of the proposed sale. Written documentation of the disposition process is important to insure the "best" price is obtained. Exceptions to the auction format for disposition, must be approved, in writing, by the Chief Investment Officer.
- 2. STRS Board or Chief Investment Officer** -- After completion of the due diligence process, the disposition will be approved or declined within delegation amounts listed in sections 9 and 10 of the investment real estate policies.
- 3. Investment Officer** -- While negotiating terms and conditions of the legal documents, STRS' legal counsel will be appraised of the negotiation progress periodically. When the documents are acceptable to the interested parties, the real estate consultant and STRS' legal counsel will issue their respective written approvals. When all terms have been finalized and approved by all parties, the documents are forwarded to the Chief Investment Officer for review and signature.

## **Management and Operations**

- 1. Investment Officer** -- The property manager or real estate advisor may periodically request cash contributions (capital call) from STRS. The investment officer receives notice of a capital call on the advisors/property manager's letterhead and signed by an authorized signatory. Capital call notice include details on the amount of cash requested, date of transfer, purpose of call, and wiring instructions.

The capital call notices are closely scrutinized by the Investment Officers. The notices are inspected to make certain they include the appropriate signatures and contain all of the information necessary to effect the wire transfer. Any discrepancies identified must be satisfactorily explained prior to processing each capital call notice.

- 2. Investment Officer** -- After confirmation of the capital call's amount due, date of transfer, and wire instructions. A purchase transaction form is then completed and signed. The purchase transaction form plus a copy of the capital call notice is forwarded to the operations unit for processing. The purpose of the purchase transaction form is two-fold: 1) to notify the Custodian to schedule payment of the capital call; and 2) to notify the Cash Management function in the Operations Unit to consider the contribution in the cash forecast.

### **Portfolio Monitoring**

- 1. Investment Officer** -- The investment real estate unit will maintain a cash database which should be updated, at least monthly, to reflect all cash contributions and distributions for each direct investment. The investment officer performs a monthly reconciliation with the master custodian to verify that all transactions are accurately recorded. The investment officer analyzes and reconciles all discrepancies.
- 2. Investment Officer** -- The investment officer performs a monthly reconciliation with the consultant for all cash flows to verify all transactions are accurately recorded on a monthly basis and capital balances are reconciled with the consultant on a quarterly basis. All discrepancies are discussed and corrected.

## INVESTMENT REAL ESTATE PORTFOLIO PROCEDURES COMMINGLED FUNDS

The Board adopted the Investment Management Plan, which was originally drafted in 1986, and has been periodically updated to reflect the changes that have occurred in the investment strategy and policy. The Investment Management Plan mandates the investment of plan assets in four broad categories: public equity, public debt, private equity, and private debt. The following reflects procedures for investment real estate, part of private equity:

### **Delegated Roles and Authority**

- 1. STRS' Board** -- Establishes the role of the investment real estate program and approves the asset allocation target, range and risk profile of the investment real estate program. Directs the Chief Investment Officer (CIO) and Real Estate Consultant to periodically report on the compliance with established policies and procedures.
- 2. Chief Investment Officer** -- Establishes the program guidelines in such areas as (1) evaluating commingled funds, (2) declining or approving of commingled funds (within the amounts delegated by the Board), and (3) establishing targets and ranges for diversification purposes.
- 3. Real Estate Consultant** -- Reports directly to the Investment Committee on matters of policy. Monitors the performance of the real estate portfolio and compliance with approved policy.

### **Acquisitions/Commitments**

- 1. Investment Officer** -- The investment real estate unit receives and reviews offering memoranda from a variety of sources. The offering memoranda provides an overview of the investment philosophy, strategy, and terms and conditions of the proposed commingled fund. The investment officer(s) review and analyze the principal terms and conditions of the proposed fund and major accomplishments of the management group.
- 2. Investment Officer** -- After analyzing the offering memoranda, if there is sufficient interest and compatibility, the investment officer may arrange a meeting with the commingled fund. Subsequent to this meeting, the investment officer(s) will evaluate the merits of the proposed commingled fund investment strategy, terms and

conditions, management's qualifications, and previous track record. A ranking is assigned between one to ten, with one being the lowest and ten the highest.

- 3. Director of Real Estate** -- The investment officer(s) will discuss the proposed commingled fund with the Director of Real Estate. After discussion, the Director of Real Estate may present the qualifications of the proposed fund to the Chief Investment Officer. A detailed due diligence process will be initiated unless the Chief Investment Officer disagrees. To facilitate the due diligence process an independent fiduciary or STRS' real estate consultant may be utilized as an advisor. Written documentation of the due diligence process is important and to be included in the material for future reference.
- 4. Investment Officer and/or Independent Fiduciary (IF)** -- Under the supervision of the Director of Real Estate, the staff and/or IF may be asked to conduct due diligence in accordance with but not limited to the following aspects:
  - A. Experience working together as a team
  - B. Identifiable track record
  - C. Special skills or industry expertise
  - D. Size of proposed fund in comparison to previous experience
  - E. Well defined and realistic investment strategies
  - F. Ability to realize profits with successful exit strategies
  - G. Ability to add value through revitalization's or acquisitions
- 5. STRS Board or Chief Investment Officer** -- After completion of the due diligence process, the commingled fund commitment will be approved or declined within delegation amounts listed in sections 9 and 10 of the policy section.
- 6. Investment Officer** -- After approval of a commitment to an investment, STRS will analyze the terms and conditions of the commingled fund. Any terms which are identified as potentially unfavorable or inconsistent with STRS' goals and objectives are then discussed and negotiated with the commingled fund. STRS may decline participation in an investment if terms considered to be "deal breakers" cannot be resolved in a satisfactory manner.
- 7. Investment Officer and STRS Legal Counsel** -- While negotiating terms and conditions of the legal commingled fund agreement documents, STRS' legal counsel will be appraised of the negotiation progress periodically. When the documents are acceptable to the interested parties, the consultant and STRS' legal counsel will issue their respective written approvals. If any of the terms are identified as

unacceptable or objectionable, then STRS or the consultant will enter into additional negotiations with the commingled fund. When all terms have been finalized and approved by all parties, the documents are forwarded to the Chief Investment Officer for review and signature.

### **Management and Operations**

- 1. Investment Officer** -- STRS' commingled fund investments periodically request cash contributions (capital call). The investment officer receives notice of a capital call on the Fund's letterhead and signed by one or more managing partners. Capital call notice include details on the amount of cash requested, date of transfer, purpose of call, and wiring instructions.

The capital call notices are closely scrutinized by the Investment Officers. The notices are inspected to make certain they include the appropriate signatures and contain all of the information necessary to effect the wire transfer. Any discrepancies identified must be satisfactorily explained prior to processing each capital call notice.

- 2. Investment Officer** -- After confirmation of the capital call's amount due, date of transfer, and wire instructions. A purchase transaction form is then completed and signed. The purchase transaction form plus a copy of the capital call notice is forwarded to the operations unit for processing. The purpose of the purchase transaction form is two-fold: 1) to notify the Custodian to schedule payment of the capital call; and 2) to notify the Cash Management function in the Operations Unit to consider the contribution in the cash forecast.

- 3. Investment Officer** -- STRS receives periodic cash distributions as a result of its participation in the commingled fund. Notices of cash distributions are sent on the partnership letterhead and contain information regarding date of distribution, amount of distribution, and a description of the source of the distribution. The investment officer reviews the distribution notice and prepares a cash distribution form to the Master Custodian. The purpose of the cash distribution form is two-fold: 1) to notify the Custodian to expect receipt of the funds, including proper accounting treatment; and 2) to notify the Cash Management function in the Operations Unit to consider the distribution in the cash forecast.

## **Portfolio Monitoring**

- 1. Investment Officer** -- The investment real estate unit will maintain a cash database which should be updated, at least monthly, to reflect all cash contributions and distributions activity for each commingled fund. The investment officer performs a monthly reconciliation with the master custodian to verify that all transactions are accurately recorded. The investment officer analyzes and reconciles all discrepancies.
- 2. Investment Officer** -- The investment officer performs a monthly reconciliation with the consultant for all cash flows to verify all transactions are accurately recorded on a monthly basis and capital balances are reconciled with the consultant on a quarterly basis. All discrepancies are discussed and corrected.
- 3. Investment Officer** -- The fund performance worksheet shall be completed on a quarterly basis. The data contained in the worksheet provides specific performance measurements including: net gain/loss in funds, total return ratio, distribution return ratio, and annual IRR.
- 4. Investment Officer** -- A market pricing report should be completed and forwarded to the master custodian on a quarterly basis. This report contains information that allows the investments made by the commingled fund to be carried at a market valuation rather than strictly at a cost basis.
- 5. Investment Officer** -- The commingled fund's performance and portfolio are closely monitored. Part of the monitoring process includes meeting the managing partners annually either in STRS' office, the Fund's office, or at neutral site. These meetings enable the investment officer the opportunity to effectively evaluate performance and investment strategy, and to interact one-on-one with the general partners. Additional reports will be provided as requested by the Chief Investment Officer, STRS Board, or Internal Audit Department.

## **Investment Real Estate Policies**

### **Definition of Risk Characteristics for Real Estate**

Investment real estate can be categorized into a risk and return spectrum comprised of low risk, moderate risk, and high risk. The following table reflects the characteristics of the three categories of risk:

#### **Low Risk**

- Expected 4%-6% real rate of return
- Traditional property types (industrial, office, apartment and retail)
- Substantially leased properties at acquisition
- No leverage on the property
- Cash flow from property is the largest component of value
- Large and diverse geographic areas

#### **Moderate Risk**

- Expected 6%-12% real rate of return
- Some lease-up risk
- Public securities (REIT, real estate company)
- Moderate leverage (20%-60% loan to value)
- Specialized property types (Timber, Hotel)
- Non economically diversified geographic areas

#### **High Risk**

- Expected 12%-20% real rate of return
- Land development
- High leverage (75% or higher loan to value)
- Appreciation largest component of value
- Currency or political (international)

**Investment Real Estate Policies  
Diversification Criteria for the Direct Portfolio**

<b>Geographical Location</b>	<b>Range</b>	<b>Target</b>	<b>12/31/97 Actual</b>
• West	30% - 50%	40%	69%
• South	15% - 35%	25%	16%
• East	10% - 30%	20%	6%
• Mid-West	5% - 25%	15%	9%
• International	0% - 10%	0%	0%

<b>Property Type</b>	<b>Range</b>	<b>Target</b>	<b>12/31/97 Actual</b>
• Industrial	15% - 35%	25%	22%
• Apartments	10% - 30%	20%	17%
• Office	30% - 50%	35%	36%
• Retail	15% - 35%	20%	25%
• Other *	0% - 10%	0%	0%

\* Other to include Land, Single Family Residential, Natural Resources and Hotels